The Internal Revenue Service Successfully Processed Individual Tax Returns During the 2001 Filing Season

September 2001

Reference Number: 2001-40-192

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

INSPECTOR GENERAL
for TAX
ADMINISTRATION

September 28, 2001

MEMORANDUM FOR COMMISSIONER, WAGE AND INVESTMENT DIVISION

Pamela J Gardiner

FROM: Pamela J. Gardiner
Deputy Inspector General for Audit

SUBJECT: Final Audit Report - The Internal Revenue Service Successfully Processed Individual Tax Returns During the 2001 Filing Season

This report presents the results of our review to determine if the Internal Revenue Service (IRS) timely and accurately processed individual income tax returns during the 2001 Filing Season.

In summary, we found the IRS successfully processed individual income tax returns during the 2001 Filing Season. This was accomplished while undergoing organizational restructuring, implementing key processing changes, and reacting to unexpected filing patterns. The IRS also made progress in implementing new tax initiatives and tax law changes. While significant progress was made in both areas, the IRS encountered some implementation problems. For example, using a computer match with Social Security Administration data, it identified 473,529 returns with errors in the spouse's social security number. However, the IRS did not always resolve these errors correctly. As a result, we estimate that the IRS incorrectly denied the personal exemption and Earned Income Credit, totaling almost $1 million, for 1,808 taxpayers whose returns posted during the week of April 29, 2001.

In addition, while the IRS did have processes in place to identify and react to unexpected events throughout the 2001 Filing Season, enhancements can be made to its contingency planning process.

Management's Response: Management's response was due on September 28, 2001. As of that date, management had not responded to the draft report.

Copies of this report are also being sent to the IRS managers who are affected by the report recommendations. Please contact me at (202) 622-6510 if you have questions or

M. Susan Boehmer, Acting Assistant Inspector General for Audit (Wage and Investment Income Programs), at (770) 936-4590.

Table of Contents

Background

The Internal Revenue Service (IRS) is the largest processor of data in the world. Most of the data for individual income tax returns are processed during each "filing season." In general, the IRS defines the filing season as the first half of each calendar year, when individuals file their tax returns. The IRS reports that most individual taxpayers usually deal with the IRS only once a year, when they file their tax returns.

In the 2001 Filing Season, the IRS received and processed tax returns through a nationwide network of 10 submission processing centers (SPC). Generally, paper tax returns and related correspondence were received at the SPCs, checked for errors, and input to the taxpayers' accounts on the IRS' computer system. Payments were deposited into the Federal Reserve Bank. If a taxpayer paid more tax than was owed, the IRS issued a refund to the taxpayer. If a taxpayer had not paid all the tax due, the IRS sent the taxpayer a notice requesting payment for the balance due. The IRS also sent the taxpayer a notice if an error was made on the return. The notice generally explained why the error occurred and any resulting balance due or refund.

The IRS has to process tax returns with refunds due within 45 days of receipt or the return due date, whichever is later, to avoid paying interest. Generally, for the 2001 Filing Season, the IRS considered a return to be timely processed if the taxpayer filed on or before April 16, 2001, and the IRS issued the refund by May 31, 2001. See Appendices VI and VII for additional details on how the IRS processes tax returns and a description of the key processes used.

The IRS faced a number of challenges during the 2001 Filing Season, including a new organizational structure and several legislated tax law changes and efforts to enhance taxpayer service.

This marked the first processing year for the IRS' new organizational structure with four operating divisions that are organized around the needs of particular groups of taxpayers. The 2001 Filing Season was also the first year of a planned 2-year processing workload transition.[1]

The IRS was also faced with the implementation of several tax law changes and customer service initiatives. For example, this was the first year the IRS validated the accuracy of the spouse's social security number (SSN).[2] The IRS also added a checkbox to the return to provide an easier way for taxpayers to authorize the IRS to discuss their return with their paid return preparer. Details of the tax law changes and customer service initiatives the IRS undertook for the 2001 Filing Season can be found in Appendix V.

This audit was conducted from January 2001 through June 2001 at the IRS' Submission Processing Headquarters offices in Cincinnati, Ohio, and New Carrollton, Maryland, and the Andover, Atlanta, Austin, Fresno, and Kansas City SPCs. The audit was performed in accordance with *Government Auditing Standards*.

The Internal Revenue Service Successfully Processed Individual Income Tax Returns

Overall, the IRS had a successful filing season.[3] This was accomplished while undergoing organizational restructuring, implementing key processing changes, and reacting to some unexpected filing patterns. While this is a significant accomplishment, we identified some additional steps the IRS can take to ensure that all aspects of its tax law changes and initiatives are implemented.

---

[1] The IRS plans to eventually move the processing workload so all individual income tax returns are processed in eight submission processing centers. The remaining two centers will process business tax returns.

[2] The spouse's SSN is generally referred to as the secondary SSN on the tax return.

[3] Our assessment of the success of the IRS filing season included only those returns where the actual return and any associated payments were received at the IRS' processing centers and processed as of the end of our audit period. Our audit excluded several million individual returns where the taxes due were paid in full when the return was filed.

The IRS processed millions of individual tax returns during the 2001 Filing Season

As of June 1, 2001, the IRS had processed approximately 109 million individual tax returns. About 37 percent (or 39.8 million) were filed electronically, an increase of approximately 13 percent over last year.[4]

The IRS had issued $148.2 billion in refunds on approximately 87 million returns. Of this total, $70.5 billion was deposited directly to taxpayers' bank accounts in lieu of paper refund checks (about an 18 percent growth over last year).[4] We selected judgmental samples of 316 returns received in January and February 2001 and determined that refunds were issued within the IRS performance goal of 40 days about 99 percent of the time. Our test showed that taxpayers requesting a direct deposit of their refunds received their refunds in an average of 22 days, whereas taxpayers with paper check refunds received theirs in an average of 29 days.

As of June 1, 2001, the IRS also identified approximately 4.11 million errors that taxpayers made when preparing their returns. Roughly 1.73 million additional errors made by paid return preparers were also identified. Common taxpayer errors included providing incorrect SSNs for dependents and incorrectly computing the refund or amount owed. Common paid preparer errors also included providing incorrect dependent SSNs and incorrect secondary SSNs (includes errors in the secondary name on the return). During this same time period, the IRS identified and corrected 5.92 million IRS return processing errors. These errors are corrected prior to completion of processing and the issuance of tax refunds as part of the regular pipeline process (see Appendix VI). One of the more common processing errors involved the incorrect data entry of the spouse's name information used in validating the secondary SSN.[4]

---

[4] We did not validate the accuracy of the IRS' statistics.

The IRS overcame processing challenges

As of June 1, 2001, the IRS expected taxpayers to file approximately 81.2 million paper returns and 42 million electronic returns and it set its work schedules accordingly. However, taxpayers did not file as expected, creating return processing challenges that the IRS was able to overcome.

As of June 1, 2001, the IRS reported lower than expected electronically filed returns of about 39.8 million. Throughout the 2001 Filing Season, the IRS expressed concerns that the slow growth in electronic filing could increase the workload on the SPCs. In fact, as of June 1, 2001, 1.6 million more paper returns had been received than were expected.

More taxpayers also filed on or near the filing deadline (normally April 15 for individuals) than had been anticipated. A similar filing pattern occurred during the 2000 Filing Season. (See Appendix VIII for additional details.)

To determine if the IRS was able to handle this increased volume, we analyzed return flows through the initial processes (mail opening and returns sorting) in five SPCs (Andover, Atlanta, Austin, Fresno, and Kansas City). We determined that the centers were able to adequately handle the volumes of returns received without any significant problems.

As previously noted, the IRS identified and corrected a significant number of taxpayer and IRS processing errors. As of June 1, 2001, the IRS reported it had identified and resolved over 19 million taxpayer and IRS processing errors. This was an increase of about 9 percent from last year.[5]

We analyzed IRS error inventory reports for the 10 SPCs during a critical processing period (late April to early May 2001) and determined that the IRS was able to manage

[5] We did not validate the accuracy of the IRS' statistics. The 19 million errors include electronic filing errors and errors in tax payments.

its large error inventories without any lengthy processing delays. Steps taken by the IRS to reduce the impact of errors on processing timeliness included making procedural changes to reduce the number of processing errors. The IRS also sent a letter to taxpayers prior to the 2001 Filing Season advising them that corrections to the secondary SSN or name used on their returns may need to be made with the Social Security Administration (SSA) to avoid having problems when filing their tax returns.

The IRS also took steps to manage its workload inventory among processing centers. Early in the 2001 Filing Season, the IRS decided it was necessary to transfer approximately 600,000 individual income tax returns in inventory in one SPC to four other processing centers. This was necessary because one SPC was at risk of not being able to process its return inventory within the 45-day interest-free period.

To determine whether this action adversely affected refund timeliness, we selected a judgmental sample of returns that had been transferred to the Austin SPC. This center received a total of 50,000 of the transferred returns. Our review of 20 returns taken randomly from 10 different groups or blocks of returns (totaling 500 returns) showed that all of the refunds were issued timely.

The IRS made considerable progress in implementing new tax initiatives

The Taxpayer Relief Act of 1997[6] (TRA 97) provided a tax credit of $500 against a taxpayer's tax liability for each child if they qualify. The credit is commonly known as the Child Tax Credit. (See Appendix V for more details.) One of the tests taxpayers must meet to qualify for the credit is that each child must be under age 17 at the end of the calendar year. The Treasury Inspector General for Tax Administration (TIGTA) reported as part of the 2000 Filing Season audit report that the IRS had not programmed its

[6] Pub. L. No. 105-34, 111 Stat. 788 (codified as amended in scattered sections of 5 U.S.C., 19 U.S.C, 26 U.S.C., 29 U.S.C., 31 U.S.C., 42 U.S.C.,and 46 U.S.C. app.).

computers to ensure that children met the age requirement.[7] The IRS implemented a computer check for the 2001 Filing Season and reported that, through June 1, 2001, it had identified and corrected 295,045 returns where the age limit was exceeded.

The TRA 97 also provided for a deduction of interest paid on education loans if certain requirements are met. (See Appendix V for more details.) For the 2001 Filing Season, the maximum deduction increased from $1,500 to $2,000. The deduction is limited based on other factors, including the taxpayer's income and filing status. We analyzed information from a judgmental sample of 35 tax returns with this deduction where the IRS had determined an error had been made. Our analysis showed that IRS controls were in place to ensure the deduction was limited to no more than $2,000 and was further limited based upon the taxpayer's income. The IRS also properly disallowed the deduction to taxpayers if they were married but filed separately.

This was the first year the IRS verified the accuracy of the spouse's (secondary) SSN before allowing the spouse's personal exemption on paper tax returns. The Personal Responsibility and Work Opportunity Reconciliation Act of 1996[8] also gave the IRS the authority to disallow the Earned Income Credit (EIC). The credit could be disallowed if the taxpayer did not provide a valid SSN for themselves, their spouse, and the child or children that qualified them for the credit. (See Appendix V for more details.) A valid SSN is one where the information provided by the taxpayer agrees with information on file with the SSA.

As of June 1, 2001, IRS' statistics showed that it identified 473,529 errors resulting in the disallowance of personal exemptions and the EIC, if applicable, on paper returns.[9] Although the IRS implemented the validation of the

---

[7] *The Internal Revenue Service Had a Successful 2000 Filing Season; However, Opportunities Exist to More Effectively Implement Tax Law Changes (Reference Number 2001-40-041 dated January 2001).*

[8] Pub. L. No. 104-193, 110 Stat. 2105.

[9] We did not validate the accuracy of the IRS' statistics.

secondary SSN, the validation process could be improved. A discussion of how the process could be improved can be found on pages 8 and 9 of this report.

The IRS also modified the U.S. Individual Income Tax Return (Form 1040A) to allow taxpayers to report capital gain distributions on the Form 1040A rather than filing a U.S. Individual Income Tax Return (Form 1040) (see Appendix V). IRS statistics for returns received through May 4, 2001, showed an estimated 1.1 million taxpayers filed a Form 1040A with capital gain distributions.[10] Our judgmental sample of 75 Forms 1040A with an entry for capital gain distributions showed that the IRS verified the correct tax was computed.

Additional steps can be taken in implementing tax law changes and initiatives

While significant progress was made in the implementation of tax law changes and related initiatives, the IRS has the opportunity to continue to improve in the following areas:

- Consistency among processing procedures, taxpayer instructions, and legislative requirements.
- Clarity of taxpayer notices.

Consistency among processing procedures, taxpayer instructions, and legislative requirements

We identified several instances where the IRS processing procedures were not consistent with either the return preparation instructions provided to taxpayers or legislative requirements. Consistency of procedures helps the IRS ensure fair and equitable treatment of all taxpayers.

Personal exemptions and the EIC were incorrectly denied during the IRS' validation of the secondary SSN. The IRS performed a computer match between the spouse's last name and SSN on a jointly filed return and information provided by the SSA. When the return information and the SSA information did not match, IRS examiners were instructed to accept the return information if additional

[10] We did not validate the accuracy of the IRS' statistics.

documentation provided with the return (Wage and Tax Statement (Form W-2), marriage license, valid driver's license, etc.) indicated the SSN was valid. If the additional documentation did not support the information on the return, the IRS denied the spouse's personal exemption and the EIC, if applicable. Although the IRS had procedures in place to accept additional information to support the spouse's SSN, the instructions taxpayers used when completing their tax return did not mention this.

As discussed previously, providing an incorrect secondary SSN was one of the most common errors made during the 2001 Filing Season (202,309 taxpayer errors and 271,220 paid tax preparer errors). During two points in the filing season, we conducted tests of individual tax returns where the IRS had denied the spouse's personal exemption and the EIC, if applicable, during its validation of the secondary SSN. Both of these tests showed that, in some instances, the IRS improperly denied the personal exemption and the EIC when the spouse's name and SSN were accurate. In addition, our tests indicated that the IRS' procedures for validating secondary SSNs had not been properly implemented. IRS processing procedures for correcting errors with secondary SSNs require IRS examiners to research the tax return and its attachments and the IRS' computer system to determine if the spouse's name and SSN used on the tax return are valid before disallowing the exemption and EIC, if applicable.

We reviewed a judgmental sample of 66 returns with secondary SSN errors processed at the Atlanta, Kansas City, and Austin SPCs during the first four weeks of return processing where the personal exemption and EIC, if applicable, were disallowed. Our test showed that in 10 of the 66 returns (15 percent) the IRS erroneously disallowed the personal exemption and the EIC, if applicable (4 of the 10 cases) totaling $12,120. We informed the IRS of this condition and it revised its validation procedures.

To determine if the validation of the secondary SSN improved later in the filing season, we reviewed a statistical sample of 193 returns with secondary SSN errors processed in the Atlanta, Austin, and Kansas City SPCs and posted to the IRS' computer system during the week of April 29, 2001, where the personal exemption and EIC, if applicable, were disallowed. Our review indicated that the processing of secondary SSN cases had not significantly improved. In 27 of the 193 (14 percent) returns reviewed, the IRS erroneously disallowed the personal exemption and the EIC, if applicable (2 of the 27 cases), totaling $14,872. These processing errors occurred because the IRS had not:

- Considered the Form W-2 and other documentation provided by the taxpayer to support the validity of the secondary SSN (16 of 27).
- Followed its current research and resolution procedures (11 of 27).

Based on our test results, we estimate the IRS erroneously disallowed the personal exemption and EIC for 1,808 taxpayers whose returns posted during the week of April 29, 2001; these errors affected a total of about $1 million. If our test results are representative of the 2001 Filing Season, the IRS may have erroneously disallowed exemptions and credits totaling about $36.5 million for over 66,000 taxpayers.

The IRS' processing procedures would have prevented some taxpayers from receiving the benefit of the third-party authorization. Before the 2001 Filing Season began, we identified a conflict between the tax return instructions to taxpayers and the IRS' processing instructions for editing tax returns based upon whether the taxpayer answered "yes" to the third-party authorization question. This year, the IRS added a checkbox to the tax return allowing taxpayers to authorize their paid return preparers to contact the IRS regarding certain issues on their tax returns.

IRS instructions for editing returns for the third-party authorization required that the return preparer's telephone number be provided before the return could be coded as a "yes." Instructions to the taxpayer did not indicate a telephone number is required to participate in the third-party authorization program. We identified this inconsistency during the planning phase of our review and alerted the IRS to this discrepancy in December 2000. IRS procedures were changed prior to the start of the 2001 Filing Season.

Our computer analysis of 10 percent of all paper returns prepared by a paid return preparer nationwide and processed as of June 1, 2001, indicated 11 percent of the returns with a "yes" answer did not provide a return preparer telephone number. If IRS procedures had not been revised, this could have resulted in an estimated 3.1 million paper returns filed for which taxpayers would not have received the benefit of the third-party authorization.

We identified an additional problem with the IRS' third-party authorization procedures. Procedures indicated that the IRS' telephone assistors would be able to research the computer system to determine if a taxpayer had authorized the return preparer to deal with the IRS on his or her behalf. We advised the IRS in early March 2001 that the procedures needed to be expanded because not all taxpayer authorizations would be found on the computer system using the current research procedures. The IRS agreed and subsequently revised the research procedures so that all taxpayer accounts with a "yes" indicated in the third-party authorization could be identified.

Clarity of taxpayer notices

We identified two taxpayer notices that could be confusing to taxpayers. The notice sent to taxpayers when the spouse's personal exemption was disallowed as part of the secondary SSN validation was incomplete. In addition, the notice sent to taxpayers filing a Form 1040A who made an error computing their capital gain distributions did not provide an adequate explanation of the error. Unclear notices can adversely affect the IRS' goal to provide America's taxpayers top quality service.

The IRS' taxpayer notice was unclear on why a spouse's personal exemption had been denied. The notice sent to taxpayers who had their spouse's personal exemption disallowed during the IRS' validation of the secondary SSN discussed only incorrect or missing SSNs. The notices did not discuss the distinct possibility that the spouse's name may not agree with SSA information. This could confuse taxpayers who receive this notice and make it more difficult for them to resolve the error.

As of June 1, 2001, the IRS had reported almost 440,000 errors on paper returns where this explanation may be inaccurate. We reviewed a judgmental sample of 177 returns in the Atlanta, Austin, and Kansas City SPCs that posted to the IRS' computer system during the week of April 29, 2001, where the taxpayer received this notice. Our test showed that 157, or about 89 percent, had the exemption disallowed because the spouse's name rather than the SSN did not agree with SSA information.

The IRS' taxpayer notice for Form 1040A capital gains errors referred taxpayers to a Form 1040 schedule. Taxpayers who benefited from the lower tax rate on capital gains but did not compute the correct income tax on Form 1040A also received an inaccurate explanation of the error made. The notice explanation told the taxpayer, "Using Part IV of Schedule D to compute your tax gives you a lower tax rate."[11] Since these taxpayers filed Form 1040A, this explanation was not applicable and could have confused the taxpayers. As of June 1, 2001, the IRS had reported over 6,000 taxpayers made this error on Form 1040A.

In addition, some taxpayers are able to report capital gain distributions on Form 1040 without having to file Schedule D. IRS estimates for tax returns received through May 4, 2001, indicate almost 20 percent of the taxpayers with capital gains and losses filing a paper Form 1040 did not have to file Schedule D to report their capital gain distributions. The IRS reports a total of 101,104 taxpayers filing a Form 1040 received this notice explanation that refers to Schedule D. Given that an estimated one of every five taxpayers filing a Form 1040 with capital gains and losses did not use the Schedule D to report capital gain distributions, it is likely a significant number of the error explanations for Form 1040 return filers were confusing as well.

[11] Part IV of Schedule D is used with Form 1040, not Form 1040A.

A similar condition was reported in the TIGTA's review of the IRS' preparations for the 2000 Filing Season. In our report *The Internal Revenue Service Could Enhance the Process for Implementing New Tax Legislation,*[12] the TIGTA recommended the IRS develop a process which ensures that actions necessary to implement a legislative act are completed timely. The TIGTA also recommended the IRS perform a quality review for Requests for Information Services[13] to ensure that each legislative provision is completely and accurately addressed.

The IRS agreed with our recommendations and responded that a process would be developed to implement new legislation, new procedures would be issued, and a new review process would be initiated to ensure that all aspects of legislative provisions were fully and accurately designed and implemented. However, the IRS was not able to provide us with a detailed, comprehensive implementation plan for the legislative provision on validation of the secondary SSNs. In addition, the IRS could not provide us with detailed plans for implementing the third-party authorization initiative and the change to Form 1040A for capital gain distributions.

We recognize that full implementation of tax initiatives can be difficult given that some tax law changes and initiatives may need to be implemented quickly. For example, implementing tax law changes enacted late in the calendar year poses a challenge for the IRS. While it may be necessary to take certain actions immediately, it is still possible to design detailed plans of implementation that can be used as a key control to identify where necessary actions have not yet been taken. These detailed plans help to ensure that the objectives of those initiatives are achieved.

[12] Reference Number 2000-40-029, dated March 2000.

[13] Tool used by the IRS to request changes to its computer systems.

Recommendation

The Director, Customer Account Services, Wage and Investment Division, should:

1. Work with other appropriate IRS officials to ensure that detailed, comprehensive plans are developed when implementing significant tax law changes and initiatives. These plans should include a process to ensure that action items are timely completed prior to the beginning of the filing season.

Management's Response: Management's response was due on September 28, 2001. As of that date, management had not responded to the draft report.

The Internal Revenue Service Can Make Enhancements to Build Upon the Successes of the 2001 Filing Season

While we found that the IRS was able to successfully process individual income tax returns while reacting to unexpected taxpayer filing patterns, the IRS can take additional steps to enhance its ability to plan for and react to those events as they occur during the filing season. We observed a number of factors that could adversely affect the IRS' plans to continue the transition of the processing workload among its SPCs. Each of these factors, if not considered during the transition, could jeopardize the IRS' ability to continue to timely process individual income tax returns.

The IRS' workload schedules and contingency planning tools could be strengthened to help it better manage unexpected events during the filing season

Taxpayer filing patterns can significantly impact IRS' processing schedules. While we did not evaluate the process the IRS used to develop its work plan and schedules, our review provided indications that these tools can be enhanced.

The IRS considers several factors in developing a work plan for the filing season, including both legislative and IRS processing changes. Work schedules are prepared from this plan to estimate when the workload or tax returns will actually be received for processing. The IRS relies on those estimates that are developed prior to the filing season. The IRS uses the work schedules to determine if needed resources are available to ensure the timely processing of tax returns.

The accuracy of work schedules is also dependent upon how closely taxpayers file in the manner expected by the IRS. We noted this filing season that individual taxpayers were filing closer to the filing deadline than the IRS had estimated. Over 29 million individual paper tax returns or about 36 percent of the total paper return receipts to date were received at or near the deadline (normally April 15 for individuals).

The IRS reported paper return receipts just prior to the filing deadline were about 1.9 million below what had been anticipated. After the filing deadline, the IRS reported paper return receipts surpassed the schedule by about 1.4 million returns.[14] A similar filing pattern existed in the 2000 Filing Season. See Appendix VIII for additional information on the return receipt patterns for the 2000 and 2001 Filing Seasons.

In developing the work schedules, the IRS needs to consider the continuing trend of later return receipts. Without accurate scheduling, the IRS increases the risk that resources will not be available when tax return receipts peak and time is critical.

The IRS does not modify its work schedules during the filing season to account for unexpected events. Instead, as the filing season progresses, the IRS relies on other tools to evaluate and account for issues such as unexpected taxpayer filing patterns. These tools included both local and national weekly meetings to discuss issues such as the IRS' transition, actual versus expected return receipts, and the volume of electronically filed returns.

Management of the filing season was also heavily reliant on the experience level of the individual SPC Division Chiefs and key analysts. The IRS plans to flatten its management structure, eliminating the Division Chiefs, prior to the 2002 Filing Season.

---

[14] We did not validate the accuracy of the IRS' statistics.

The IRS does have certain contingency tools in place to identify and react to unexpected events throughout the filing season. This includes the IRS' ability to transfer return inventory among its SPCs when it appears one or more centers may be unable to timely process its inventory. However, the IRS' ability to redistribute inventory will be significantly affected as it continues its transition to eight individual tax return processing centers and two business return processing centers. For example, over 600,000 individual tax returns were transferred during the 2001 Filing Season to other centers, including the 2 centers that were planned to receive only business returns in the 2002 Filing Season.

Even though the IRS modified its transition plan to allow these two centers to process a limited volume of individual returns next year, these centers' business return workload may make it more difficult to transfer returns next filing season to those centers.

In addition to the later filing pattern and the changes to workloads among the SPCs, we also found other factors that could affect IRS work plans and schedules. These factors are:

- Slower than expected growth in electronic filing affects IRS plans to realign its processing workload.
- Taxpayers' and paid return preparers' lack of compliance with changes in return filing locations could make it difficult for the processing centers to timely process tax returns.

Slower than expected growth in electronic filing affects IRS plans to realign its processing workload. Electronic filing growth has a direct and significant impact on IRS plans to have eight centers process individual tax returns and two centers process business tax returns. Electronic filing is also the key factor in the IRS' plans for additional shifting of the workload among the processing centers in future filing seasons. The IRS reported 39.8 million electronically filed returns had been processed through

May 31, 2001.[15] While this represents an increase of about 13 percent over last year, it was 5 percent, or over 2 million returns, below the goal for this filing season.

This shortfall will likely increase the paper return workload on the processing centers for next year by more than the IRS had earlier anticipated. Preliminary IRS estimates show it expects to receive 5.7 million more paper returns nationwide for the 2002 Filing Season than it had planned for.[15]

The IRS has recognized the slower than expected growth in electronically filed returns poses significant constraints on its Fiscal Year 2002 transition plan and has decided to delay full implementation. Next filing season, all business returns will be processed at the 2 centers as planned; however, these 2 centers will also process about 7 million individual income tax returns.

Taxpayers' and paid return preparers' lack of compliance with changes in return filing locations could make it difficult for the processing centers to timely process tax returns. As electronic filing increases, the current processing center workload should decline. As a result, the IRS plans to annually change processing workloads depending upon future electronic filing growth. The workload changes mean that taxpayers in certain states will be told to file their individual returns in a different location. For example, in the 2001 Filing Season, taxpayers in 12 states were told to file their individual returns in a different location from the previous year.

To determine the overall level of compliance for both paid preparer and self-prepared returns during the 2001 Filing Season, we analyzed returns filed nationwide from January to April 2001 and identified some important trends. This analysis looked at approximately 10 percent of all paper returns prepared by paid preparers. It also included analysis of self-prepared returns with education credits claimed. The latter analysis was done to provide us with statistics on a larger population of self-prepared returns. Our analysis showed paid preparers were more than twice as likely to file

[15] We did not validate the accuracy of the IRS' statistics.

their clients' returns in the wrong location than taxpayers who prepared their returns themselves. Our analysis of over 278,000 paid preparer returns and over 235,000 self-prepared returns showed filing location errors of approximately 9 percent and 4 percent, respectively.[16]

During our review, the IRS reported receiving higher than expected business tax return receipts in the eight individual returns SPCs.[17] We identified during the planning phase of our review an error in an annual commercial tax publication that is used by taxpayers and paid preparers that may have contributed to the higher than expected business return receipts.

The 2001 tax publication listed incorrect locations for where taxpayers should file business tax returns. We informed the IRS of the error prior to the start of the 2001 Filing Season and it took action to inform the publisher of the error.

This publication error may have been partially responsible for taxpayers and paid return preparers filing business tax returns in the wrong location. However, our analysis of the filing patterns of paid preparers on individual income tax returns is an indicator that preparers likely would not have filed business tax returns in the correct locations, regardless of the accuracy of the 2001 tax publication.

Even though the IRS made significant changes to where taxpayers were required to file their returns, it did not perform any detailed analysis of taxpayers' compliance with these changes during the 2001 Filing Season. A real-time analysis during the filing season could have been used early in the filing season to gather information that could have been used to better educate taxpayers and paid return preparers in those states where errors were particularly significant.

The IRS will be changing the individual return filing locations in 15 states affecting an estimated 15.5 million taxpayers in the 2002 Filing Season. This is the second year

---

[16] These returns were judgmentally selected for review.

[17] We did not validate the accuracy of the IRS' statistics.

in a row that 3 of these 15 states will change their filing location. It is important that the IRS take steps during the next filing season to timely analyze whether taxpayers and paid preparers are filing in the correct locations. The receipt of unexpectedly large volumes of incorrectly filed returns could affect the processing centers' ability to timely process tax returns.

While the IRS was able to successfully address unexpected events as they occurred, such as higher than expected paper return receipts during the 2001 Filing Season, it is possible that this will become more difficult in future filing seasons with these changes. To enhance contingency planning, the IRS needs to develop analytical tools prior to next filing season that will assess actual filing patterns as they occur during the filing season and project the potential effect on each of the SPCs as peak filing approaches. An example would be calculating the electronic filing shortfall and estimating the additional paper return receipts that SPC could expect to receive. This would become part of the overall return workload management during the filing season.

The factors we have discussed may significantly impact the success of the IRS' planned changes for the 2002 and future filing seasons. It is critical to the success of the IRS transition efforts and to the quality of service to taxpayers that it take additional steps to carefully analyze taxpayer filing patterns for future filing seasons to ensure work schedules are as realistic as possible. It is also important that the IRS enhance its contingency planning tools to be able to timely react to unexpected changes and ensure the continued ability of its processing centers to process tax returns timely.

Recommendations

The Director, Submission Processing, Wage and Investment Division, should:

2. Use timely analysis of taxpayer filing patterns as a tool to assist the IRS in determining what additional actions should be taken as the current filing season progresses to

ensure tax returns are filed in the correct locations and to assist in planning for the following filing season.

3. Enhance contingency planning tools to ensure timely reaction to unanticipated changes that occur during the processing season.

Appendix I

Detailed Objective, Scope, and Methodology

The overall objective of this review was to determine whether the Internal Revenue Service (IRS) timely and accurately processed individual income tax returns during the 2001 Filing Season. We conducted the following tests to achieve this objective:

I. Determined whether the IRS had sufficient computer capacity to timely resolve taxpayer errors.

   A. Reviewed national IRS return production and inventory reports and compared actual return volumes with projected return volumes.

   B. Discussed what processes are used by the Director and his or her headquarters staff and staffs at the Atlanta, Austin, and Kansas City Submission Processing Centers (SPCs) to plan for unanticipated tax return receipts, including whether any contingency plans had been developed.

   C. Attended weekly SPC meetings throughout the 2001 Filing Season in Kansas City and Austin to keep informed of any national or local issues that were affecting returns processing.

   D. Contacted IRS national analysts responsible for the monitoring of individual return receipts and processing to obtain weekly inventory reports and to discuss any potential processing problems that may have surfaced.

   E. Monitored both the IRS internal web site for Submission Processing and the IRS public web site for any discussion of problems affecting the 2001 Filing Season.

   F. Participated in national IRS Submission Processing weekly calls throughout the 2001 Filing Season to keep informed on any problems occurring nationwide.

   G. Analyzed the receipt of individual tax returns processed during the week of April 23, 2001, at five SPCs (Andover, Atlanta, Austin, Fresno, and Kansas City) to determine whether each of the centers was able to handle the large volume of returns received at the filing deadline of April 16, 2001.

   H. Evaluated nationwide IRS inventory reports on the numbers of returns with errors that required corrective action, to determine whether system capacity was being exceeded.

I. Used the computer to identify individual tax returns the IRS identified as having errors with secondary social security numbers (SSN) that resulted in the disallowance of personal exemptions and the Earned Income Credit (EIC), if claimed. This computer analysis was used to identify returns for review to determine the appropriateness of IRS actions.

J. Reviewed the IRS processing procedures for correcting secondary SSN errors, including the taxpayer error explanations used to explain the errors made.

K. Reviewed a judgmental sample of 66 returns from 3,692 returns with secondary SSN errors processed at the Atlanta, Kansas City, and Austin SPCs during the first 4 weeks of return processing where the personal exemption and EIC, if claimed, were disallowed to initially determine if the returns were being processed correctly.

L. Reviewed a statistical sample of 193 returns with secondary SSN errors processed in the Atlanta, Austin, and Kansas City SPCs and posted to the IRS' computer system during the week of April 29, 2001, where the personal exemption and EIC, if claimed, were disallowed.

M. Reviewed a judgmental sample of 177 returns with secondary SSN errors processed at the Atlanta, Austin, and Kansas City SPCs and posted to the IRS' computer system during the week of April 29, 2001 to determine if the cause for the secondary SSN errors was the secondary names or the numbers entered on the returns.

N. Obtained nationwide IRS reports on both taxpayer and IRS processing errors periodically throughout the 2001 Filing Season.

O. Analyzed data by the taxpayer's tax return zip code for both returns prepared by paid preparers and self-prepared returns to determine whether taxpayers were filing in the correct locations.

P. Selected a judgmental sample of 20 returns from 10 different groups or blocks of 500 returns that were originally received at the Philadelphia SPC but were transferred as part of the 50,000 returns sent to the Austin SPC, to initially determine if the returns were timely processed.

Q. Selected judgmental samples of a total of 316 returns received in January and February 2001 at the Atlanta, Austin, and Kansas City SPCs to initially determine if refunds were issued within the IRS processing goal of 40 days.

II. Determined whether certain tax law changes were correctly implemented during the 2001 Filing Season.

A. Researched changes to the tax laws for Tax Year (TY) 2000 to determine what changes would significantly affect individual taxpayers.

B. Identified by computer all individual tax returns with entries for the deduction for student loan interest and analyzed a judgmental sample of 35 returns processed in early February 2001 where the IRS had determined a taxpayer error had been made in computing the deduction to determine if the IRS was correctly limiting the deduction per the applicable tax laws.

III. Determined whether certain changes to IRS tax forms were correctly implemented during the 2001 Filing Season.

A. Discussed changes planned to the IRS tax forms with the IRS Submission Processing staff in New Carrollton, Maryland.

B. Researched IRS procedural changes made to implement the IRS tax forms changes and determined if they were consistent with the IRS objectives for making the forms changes.

C. Identified by computer approximately 10 percent of all returns prepared by paid preparers nationwide and processed as of June 1, 2001, throughout the 2001 Filing Season to determine if the IRS was properly implementing the third-party authorization (checkbox) initiative.

D. Analyzed return information from our computer file of 10 percent of all returns prepared by paid preparers processed over a 21-week period ending June 1, 2001 to determine the volume that indicated a “yes” response to the checkbox question but where the telephone number of the paid preparer had not been provided.

E. Reviewed the IRS error explanations used to explain to taxpayers the errors made when computing tax when capital gain distributions were reported.

F. Identified by computer 8,595 U.S. Individual Income Tax Returns (Form 1040A) with an entry for capital gain distributions processed over a 12-week period at the Atlanta, Austin and Kansas City SPCs and selected a judgmental sample of 75 returns to determine if the IRS was verifying that the correct tax computation was made and errors made were correctly identified.

G. Obtained IRS TY 2000 Taxpayer Usage Study reports issued during the 2001 Filing Season as one source to determine the number of taxpayers taking advantage of IRS tax initiatives such as the checkbox and the ability to report capital gain distributions on Form 1040A.

Appendix II

Major Contributors to This Report

M. Susan Boehmer, Acting Assistant Inspector General for Audit (Wage and Investment Income Programs)
Gary Young, Acting Director
Deann Baiza, Audit Manager
Linda Bryant, Senior Auditor
Sharon Buford, Senior Auditor
John Hawkins, Senior Auditor
Carl Parmer, Senior Auditor
D. Hal Schultz, Senior Auditor
Sharon Summers, Senior Auditor
Karen Fulte, Auditor
Sharla Robinson, Auditor
Bonnie Shanks, Auditor

Appendix III

Report Distribution List

Commissioner N:C
Director, Communications Assistance, Research and Education W:CAR
Director, Customer Account Services W:CAS
Director, Media and Publications W:CAR:MP
Director, Strategy and Finance W:S
Director, Submission Processing W:CAS:SP
Director, Tax Forms and Publications W:CAR:MP:FP
Deputy Director, Submission Processing W:CAS:SP:D
Director, Legislative Affairs CL:LA
Director, Office of Program Evaluation and Risk Analysis N:ADC:R:O
Chief Counsel CC
National Taxpayer Advocate TA
Office of Management Controls N:CFO:F:M
Director, Andover Submission Processing Center
Director, Atlanta Submission Processing Center
Director, Austin Submission Processing Center
Director, Fresno Submission Processing Center
Director, Kansas City Submission Processing Center

Appendix IV

Outcome Measures

This appendix presents detailed information on the measurable impact that our recommended corrective actions will have on tax administration. These benefits will be incorporated into our Semiannual Report to the Congress.

Type and Value of Outcome Measure:

- Taxpayer Entitlements – Potential; 1,808 taxpayers were incorrectly denied personal exemptions and the Earned Income Credit (EIC) in certain cases resulting in potential erroneous overassessments of tax totaling $995,864 (see page 2).

Methodology Used to Measure the Reported Benefit:

From 3 submission processing centers, a statistical sample of 193 returns was selected from a population of individual income tax returns processed over a 1-week period in April 2001. This sample was selected from a total of 12,913 returns that were identified by computer to have been assigned one of two possible notice codes pertaining to the disallowance of the personal exemption and EIC, if applicable, because of an invalid secondary social security number (SSN). This test was conducted to determine the potential impact of taxpayers being incorrectly denied personal exemptions and the EIC, if claimed. The sample size of 193 returns was derived using sampling criteria of a 15 percent expected error rate, a 95 percent confidence level, and a precision of plus or minus 5 percent. The expected error rate was based upon our initial judgmental sample of 66 returns from 3,692 returns processed during the first 4 weeks of the 2001 Filing Season, where we identified 10 returns in error (15 percent).

Our analysis of the returns and the taxpayer account information on file with the Internal Revenue Service (IRS) indicated that in 27 of these 193 returns (14 percent), the IRS erroneously disallowed the personal exemption of the taxpayer’s spouse. In 2 of the 27 returns, the EIC was also erroneously disallowed. The result was that taxes were overassessed totaling $14,872 on these 27 returns, or an average of $550.81. Applying the error rate of 14 percent to the total population sampled, the potential number of taxpayers adversely affected totals 1,808 taxpayers (14 percent times 12,913). Applying the average dollar impact from our test, a total of $995,864 (1,808 times $550.81) in taxes were erroneously overassessed.

Type and Value of Outcome Measure:

- Taxpayer Burden – Potential; 3,078,893 taxpayers would not have received the benefit of an IRS initiative if the IRS had not made changes to its procedures regarding paid preparer telephone numbers (see page 2).

Methodology Used to Measure the Reported Benefit:

Our estimate is based upon an analysis of approximately 10 percent of all paid preparer individual tax returns processed nationwide over a 21-week period from January to May 2001. Using the computer, we identified paid preparer returns by checking for the presence of a paid preparer taxpayer identification number (TIN) on the return. We identified by computer an approximate 10 percent file of these returns by using the last digit of this TIN. Also, the telephone number issue was applicable only to paper returns. For the 21-week period, a total of 3,069,072 returns were analyzed representing 10 percent of the paper returns with paid preparers. For 1,852,920 of these returns, the checkbox indicator was a "yes" per the code recorded by the IRS from the return. In 205,931 of these 1,852,920 returns (11 percent), a preparer telephone number did not exist. We applied this percentage against IRS statistics based upon the IRS' statistical samples of returns. The IRS Tax Year 2000 Taxpayer Usage Study for returns received from January 2, 2001, through May 4, 2001, indicated that an estimated 27,989,936 paper returns were received that were prepared by paid preparers and that the checkbox question was answered "yes." If our error percentage of 11 percent is representative of the entire population of paid preparer returns with the checkbox question answered "yes," a potential of 3,078,893 taxpayers would not have received the benefit of this authorization.

Type and Value of Outcome Measure:

- Taxpayer Burden – Actual; 6,096 taxpayers filing a U.S. Individual Income Tax Return (Form 1040A) and reporting capital gain distributions received incorrect explanations to errors made in computing their income tax by not properly considering the tax rate on capital gain distributions (see page 2).

Methodology Used to Measure the Reported Benefit:

The 6,096 erroneous explanations are the total number of paper returns processed through June 1, 2001, per the IRS, with an error involving capital gains and the tax computation on Form 1040A returns. The IRS information is from a system that provides counts of the actual number of paper returns assigned specific notice codes that are used to generate the applicable notice explanation.

Appendix V

Overview of Tax Law Changes and Initiatives

For the 2001 Filing Season, the Internal Revenue Service (IRS) implemented several tax law changes and customer service initiatives. Following is a brief synopsis of each of the changes and initiatives that are commented on in this report.

Tax Law Changes

Secondary Social Security Numbers (SSNs) - The Personal Responsibility and Work Opportunity Reconciliation Act of 1996[1] requires taxpayers to provide valid SSNs for themselves, their spouses, and their dependents when claiming the Earned Income Credit on returns due after September 21, 1996. In addition, the Small Business Job Protection Act of 1996[2] requires taxpayers to provide valid taxpayer identification numbers, which for most taxpayers is the SSN, for all personal exemptions claimed.

Child Tax Credit - The Taxpayer Relief Act of 1997[3] (TRA 97) provided for a tax credit of $400 beginning with Tax Year (TY) 1998 and increasing to $500 in tax years thereafter, for each qualifying child under the age of 17 at the end of the calendar year. Other limitations such as the taxpayer's income can reduce or eliminate eligibility for the tax credit. The Economic Growth and Tax Relief Reconciliation Act of 2001[4] provided for an additional increase in the credit to $600 for TY 2001 and an eventual increase to $1,000 in TY 2010.

Student Loan Interest Deduction – The TRA 97 provides for an income tax deduction for interest charges due and paid by the taxpayer on qualified education loans. The maximum deduction is being phased in over a 4-year period that began with a limit of $1,000 in TY 1997 and increases by annual increments of $500. For the 2001 Filing Season, the maximum deduction could not exceed $2,000. The deduction is limited by other factors such as the taxpayer's income and filing status. For example, the deduction is not allowed for taxpayers that are married but filing separate returns. The deduction is also not allowed for taxpayers that are claimed as a dependent on another taxpayer's (normally the taxpayer's parent) tax return.

---

[1] Pub. L. No. 104-193, 110 Stat. 2105.

[2] Pub. L. No. 104-188, 110 Stat. 1755.

[3] Pub. L. No. 105-34, 111 Stat. 788 (codified as amended in scattered sections of 5 U.S.C., 19 U.S.C, 26 U.S.C., 29 U.S.C., 31 U.S.C., 42 U.S.C.,and 46 U.S.C. app.).

[4] Pub. L. No. 107-16, 115 Stat. 38.

Initiatives

Third-Party Authorization (Checkbox) Initiative - The 2001 Filing Season was the first year for this initiative. This came about as a direct result of input from external stakeholders, including groups representing paid tax return preparers. This checkbox was added to the individual tax return forms to allow a taxpayer to indicate that the paid return preparer is authorized to contact the IRS to resolve issues related to the processing of the client's tax return. It is designed to lessen the burden on the taxpayer by avoiding the need to file a Power of Attorney and Declaration of Representative (Form 2848), which would otherwise be necessary.

Capital Gain Distributions - The IRS added a line to the 2000 U.S. Individual Income Tax Return (Form 1040A) where taxpayers could report capital gain distributions. This was done to reduce the burden on individual taxpayers if they would otherwise be eligible to file this shorter form versus the longer U.S. Individual Income Tax Return (Form 1040).

Appendix VI

Overview of Pipeline Processing

When a tax return is received at a Submission Processing Center, it progresses through what the Internal Revenue Service (IRS) calls “Pipeline Processing.” This system of operation starts at the loading dock when tax returns are received. From the dock, tax returns are taken to the Receipt and Control area to be run through the Service Center Automated Mail Processing System, which reads the bar-coded envelopes and initially sorts the tax returns.

Next, clerks in the Extraction area open and sort the mail. Tax returns with payments attached go to the Remittance Processing section to have the payments credited to the taxpayers’ accounts and deposited to the United States Treasury. The tax returns are then sent to the Code and Edit section to be checked for accuracy and prepared for further processing.

All other types of returns, such as balance due and refund, are batched by category and input on the Batch Block Tracking System. The returns are sent to the Code and Edit section to be individually checked for accuracy and completeness and then prepared for further processing.

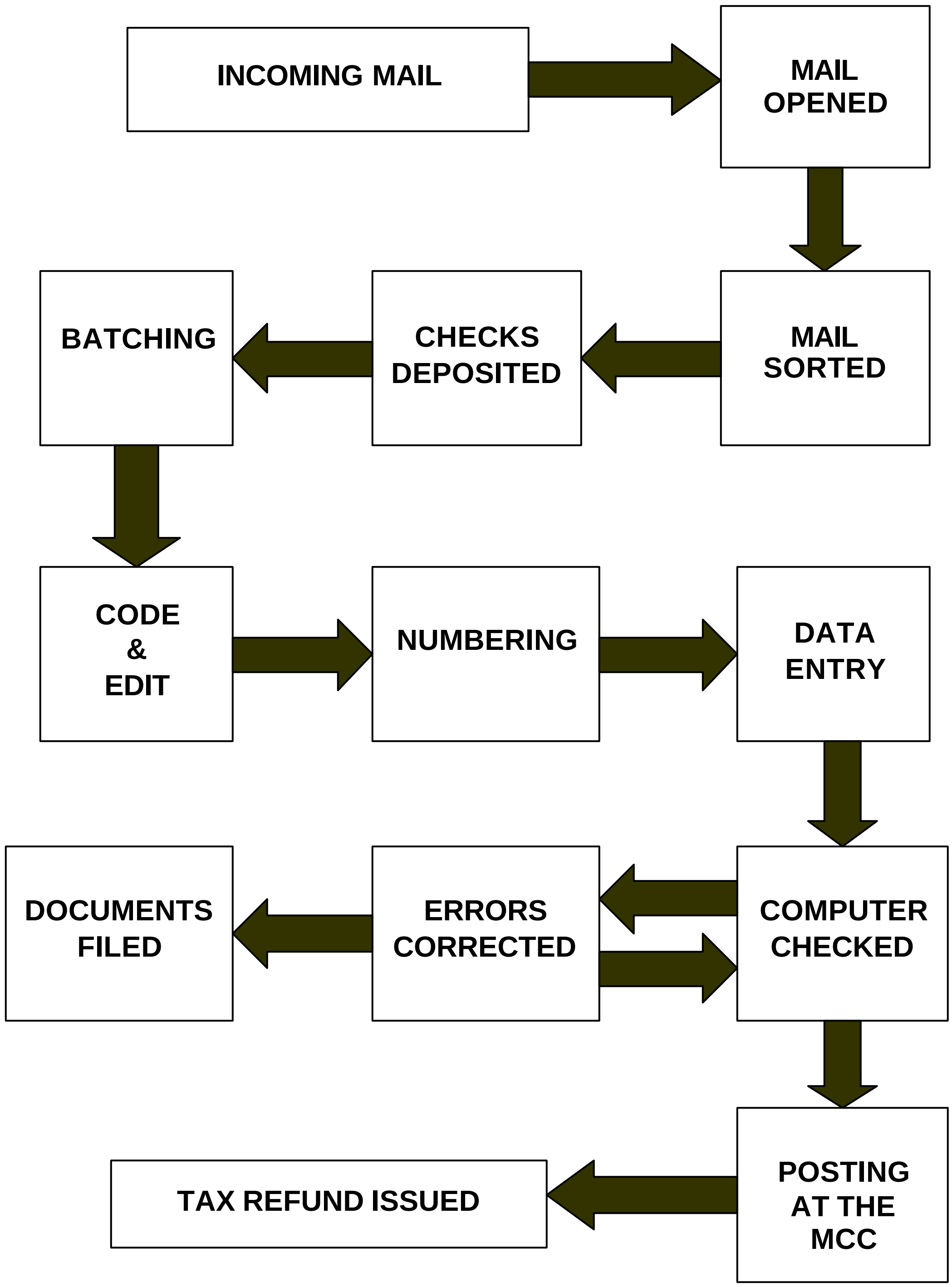
When returns arrive in the Integrated Submission and Remittance Processing area, data are entered into the computer system, verified, and relayed onto magnetic tape for further processing, math verification, and correction, if necessary.

Finally, magnetic tapes containing tax data are sent to the Martinsburg Computing Center (MCC) for posting to the IRS Masterfile.[1] The MCC generates refund tapes that are sent to the Department of the Treasury Financial Management Services (FMS). The FMS issues refund checks weekly.

The following flowchart provides a graphical overview of Pipeline Processing:

[1] The Masterfile is the IRS database that stores various types of taxpayer account information. This database includes individual, business, and employee plans and exempt organizations data.

PIPELINE PROCESSING



Appendix VII

Key Processes

We reviewed judgmental samples of returns in the Internal Revenue Service's (IRS) return processing pipeline to determine whether the returns were timely and accurately processed. Some of the key pipeline processes are as follows:

Receipt and Control Branch - This branch is the entry point for returns and correspondence received from taxpayers. Employees in Receipt and Control sort the mail, prepare tax payments for deposit, and batch returns and documents.

Remittance Processing Section - This section is responsible for depositing payments received from taxpayers. Generally, all payments received must be deposited within 24 to 48 hours of receipt. These payments are also credited to the taxpayers' accounts.

Code and Edit Section - This section ensures that the correct information from tax documents is identified for subsequent input to the IRS computer systems. Work is received from the Receipt and Control Branch and processed based on priorities. Refund returns are processed first. Employees review each document for conditions that make it unprocessable, such as missing schedules and supporting forms. They determine whether the return is signed. Employees also review the amounts claimed as deductions or credits that are not allowable by law or reflect some other type of non-compliance.

Error Resolution System (ERS) - This system is used to correct errors made by taxpayers or IRS employees during the initial processing of tax returns. After data entry operators input information from a paper tax return into the IRS' computer system, the computer conducts various checks to verify the accuracy of the information. If the data input do not pass one or more of the checks (math verification, filing status is consistent with standard deduction taken, etc.), an error condition is identified. Returns that do not pass these checks are sent to the ERS. Employees review these returns, correct the errors, and send taxpayers appropriate notices, if necessary.

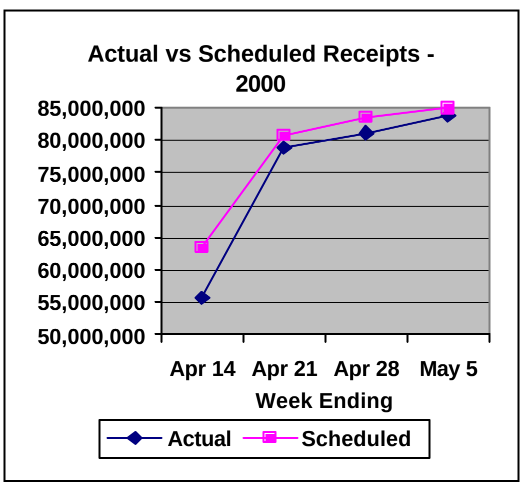
Appendix VIII

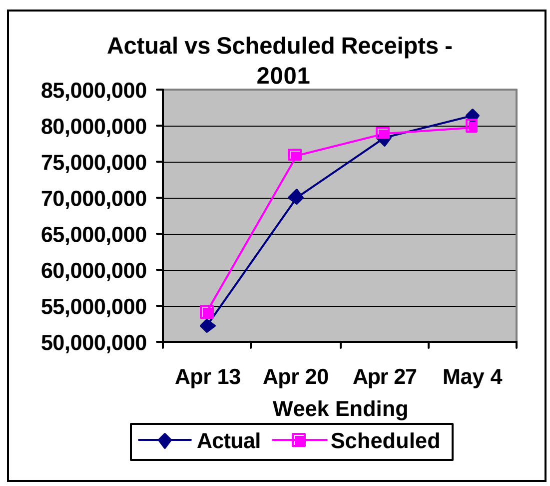
Comparison of Actual Tax Return Receipts Versus Expected Return Receipts

The graphs below show that taxpayers filed their individual tax returns later than the Internal Revenue Service (IRS) had anticipated in both the 2000 and 2001 Filing Seasons. These graphs were created using the IRS' return receipt statistics. We did not validate the IRS' data.

The IRS uses its workload schedules to ensure needed resources are available in each of its submission processing centers to timely process tax returns. The IRS' ability to timely process incoming tax returns is significantly affected when large variances exist between scheduled and actual return receipts.

The dates shown for receipt volumes do not correlate with the actual return due date (normally April 15) because it takes the IRS several days to process and sort incoming mail during this peak time period. For example, the return receipts for April 15 are not accurately reflected until receipt volumes for the last date in April and the first date in May.





The Internal Revenue Service Successfully Processed Individual Tax Returns During the 2001 Filing Season